TRANSCRIPT OF RECORD

Supreme Court of the United States

OCTOBER TERM, 1944

No. 93

W. G. CHOATE, PETITIONER,

vs.

COMMISSIONER OF INTERNAL REVENUE

ON WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE TENTH CIRCUIT

PETITION FOR CERTIORARI FILED MAY 23, 1944.

CERTIORARI GRANTED OCTOBER 9, 1944.

SUPREME COURT OF THE UNITED STATES

OCTOBER TERM, 1944

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COMMISSIONER OF INTERNAL REVENUE

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JUDD & DETWEILER (INC.), PRINTERS, WASHINGTON, D. C., NOVEMBER 13, 1944.

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[fol. 1]

IN THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE TENTH CIRCUIT

No. 2789

W. G. CHOATE, Petitioner,

v.

COMMISSIONER OF INTERNAL REVENUE, Respondent

No. 2790

COMMISSIONER OF INTERNAL REVENUE, Cross Petitioner,

v.

W. G. CHOATE, Cross Respondent

DESIGNATION OF PARTS OF RECORD TO BE PRINTED—Filed August 16, 1943

The Taxpayer W. G. Choate designates the following portions of the record to be printed as the consolidated record in the above cases:

Docket Entries.
Amended Petition.
Answer to Amended Petition read into record.
Agreed Statements of Facts.
Exhibits 1-11 inclusive.
Memorandum Findings of Fact and Opinion.
Decision.
Taxpayer's Statement of Points.
Commissioner's Statement of Points.

Vinson, Elkins, Weems & Francis, by James H. Yeatman, Attorney for Taxpayer.

[fol. 2] Service of copy of this designation acknowledged this 12th day of August, 1943.

Sam'l O. Clark, Jr., Attorney for Commissioner.

[File endorsement omitted.]

[Cross-petitioner's designation filed August 11, 1943, is identical with petitioner's designation which appears on page 1.]

[Caption omitted.]

[fol. 3] BEFORE THE UNITED STATES BOARD OF TAX APPEALS, WASHINGTON, D. C.

DR. W. G. CHOATE, Petitioner,

vs.

COMMISSIONER OF INTERNAL REVENUE, Respondent

Docket No. 107,888

AMENDED PETITION—Filed May 5, 1942

The above-named petitioner hereby petitions for a redetermination of the deficiency set forth by the Commissioner of Internal Revenue in his notice of deficiency (Bureau Symbols: Dallas-Ira:90-D-D) dated March 20, 1941; and as a basis of his proceedings alleges as follows:

I

The petitioner is an individual with principal offices located at Cisco, Texas. The return for the period here involved was filed with the Collector of Internal Revenue for the Second District of Texas, at Dallas, Texas.

II

The notice of deficiency (a copy of which is attached and marked Exhibit "A") was mailed to the petitioner on March 20, 1941.

III

The taxes in controversy are income taxes for the calendar year 1938, and in the amount of $2,015.58.

IV

The determination of tax set forth in the said notice of deficiency is based upon the following errors:

(a) In this determination of petitioner's distributive share of the partnership income of Choate and Hogan for [fol. 4] the year 1938, the respondent erred in his determination that said partnership did not make a sale of an interest in the Baker lease during said year and in failing and refusing to compute the gain or loss thereon in the manner

provided by law for computing the gain or loss on the sale of property;

(b) If it be determined that his interest in the Baker leasehold estate was not sold, then it is averred in the alternative that the members of the partnership parted with all of their rights, title and interest in and to the equipment of said leasehold estate, and that respondent erred in not reducing the gain which he determined that the partnership realized on the transaction by the full amount of the depreciated cost of the equipment on said lease, which amounted to $23,090.60;

(c) If it be determined that neither an interest in the Baker leasehold estate, nor the equipment thereon, was sold during the taxable year, then it is averred in the alternative, that respondent erred in not reducing the gain realized on the transaction by cost depletion according to the depleted leasehold cost plus the depreciated equipment cost, which amounted to $46,674.38, at the time the transaction occurred.

V

The facts upon which the petitioner relies as the basis of this proceeding are as follows:

(a) (b) Capital Gain from Sale of Baker Lease

Under date of December 3, 1936, the Continental Oil Company of Ponca City, Oklahoma, executed an instrument bearing the caption "Partial Assignment of Oil and Gas Lease,"—to Roy R. Brown of Amarillo, Texas. The instrument in question relates to what is known as the Baker Lease; and a copy of such instrument is attached hereto marked Exhibit "B".

Under date of December 18, 1936, the said Roy R. Brown executed a written instrument under the terms of which an interest in the Baker Lease was assigned to Fred T. Hogan and L. H. Choate; and a copy of such instrument is attached hereto and marked Exhibit "C".

[fol. 5] Upon receipt of the Baker Lease from the said Roy R. Brown, the said Fred T. Hogan and L. H. Choate proceeded to organize a certain joint venture (or partnership) known as Choate & Hogan of Midland, Texas. It was understood and agreed that the said Choate & Hogan

would own, develop, and operate the Baker Lease, owning property and *shawing* in profits and losses as follows:

	Interest
Choate and Choate	50%
Fred T. Hogan (and wife)	50%
Total	100%

Thereafter, Choate and Hogan did proceed to develop and operate the Baker Lease; and, under date of August 22, 1938, L. H. Choate and Fred T. Logan executed a certain instrument described as "Assignment of Oil and Gas Lease, L. H. Choate and Fred T. Hogan to Sylva Oil Company." The instrument in question relates to the sale of the Baker Lease to the Sylva Oil Company, and a copy of such instrument is attached hereto and marked Exhibit "D".

During the said year 1938, Choate & Hogan realized a gain from the sale of the Baker Lease to the Sylva Oil Company (including a loss from the sale of equipment situated on said lease), a statement of which follows:

[fol. 6]

	Leasehold	Equipment	Total
Sale Price	$98,454.70	$11,545.30	$110,000.00
Less Cost of Sale: Gross Cost	$33,391.80	$30,206.49	$ 63,598.29
Less—Reserves for Depletion and Depreciation	9,808.02	7,115.89	16,923.91
Net Cost of Sale	$23,583.78	$23,090.61	$ 46,674.38
Gross Gain from Sale	$74,870.92	*$11,545.80*	$ 63,325.62
Less Commission Paid	3,000.00		3,000.00
Net Gain from Sale	$71,870.92	*$11,545.80*	$ 60,325.62
Taxable Gain from Sale (Section 117, Revenue Act of 1938)	$47,913.95	*$11,545.80*	$ 36,368.65

* Figures in italics in red on typewritten copy.

In his notice of deficiency, the respondent determined that Choate & Hogan realized from the transaction under consideration an alleged "bonus" arising from the sublease of the Baker Lease to the Sylva Oil Company,—a summary statement of which follows:

"Oil Income"		$110,000.00
Less—Depletion	$30,250.00	
Less—Commission	$3,000.00	33,250.00
Net Income		$ 76,750.00

As above stated, the said Baker Lease was owned and operated by a certain partnership, known as Choate and Hogan; and the members of that firm were Choate and Choate and Fred T. Hogan and Wife. The said Choate and Choate is likewise a partnership, the members thereof being L. H. Choate and wife (50 percent) and Dr. W. G. Choate (50 percent).

Wherefore, the petitioner prays that the Board may hear [fol. 7] the proceedings and determine that there is no deficiency in the tax for the year 1938, in any amount whatsoever.

Signed, James H. Yeatman, Counsel for Petitioner, 11th Floor Esperson Building, Houston, Texas.

April 29, 1942.

Duly verified by Dr. W. G. Choate.

EXHIBIT "A" TO AMENDED PETITION

Treasury Department, Internal Revenue Service, 422 Federal Building, Dallas, Texas

Dallas Diyision.

Dallas IRA :90D-D

Dr. W. G. Choate, c/o L. H. Choate, Cisco, Texas.

SIR:

Your are advised that the determination of your income tax liability for the taxable year ended December 31, 1938, discloses a deficiency of $2,015.58 as shown in the statement attached.

In accordance with the provisions of existing internal revenue laws, notice is hereby given of the deficiency mentioned.

Within 90 days (not counting Sunday or a legal holiday in the District of Columbia as the 90th day) from the date of the mailing of this letter, you may file a petition with the United States Board of Tax Appeals for a redetermination of the deficiency.

Should you not desire to file a petition, you are requested to execute the enclosed form and forward it to Internal Revenue Agent in Charge, for the attention of G:RLP. The signing and filing of this form will expedite the closing of your return by permitting an early assessment of the deficiency, and will prevent the accumulation of interest, since the interest period terminates 30 days after filing [fol. 8] the form, or on the date assessment is made, whichever is earlier.

Respectfully, Guy T. Helvering, Commissioner, by (Signed) B. W. Wilde, Internal Revenue Agent in Charge.

Enclosures: Statement, Form of Waiver.
EWG/md

STATEMENT

Dallas IRA:90D-D

Dr. W. G. Choate, c/o L. H. Choate, Cisco, Texas.

Tax Liability for the Taxable Year Ended December 31, 1938

	Liability	Assessed	Deficiency
Income Tax	$2,832.77	$817.19	$2,015.58

In making this determination of your income tax liability, careful consideration has been given to the report of examination dated August 31, 1940; to your protest executed October 11, 1940; and to the statements made at the conference held on December 9, 1940.

A copy of this letter and statement has been mailed to your representative, Mr. Claude Collard, 403 Petroleum Building, Fort Worth, Texas, in accordance with the authority contained in the power of attorney executed by you and on file in this office.

Adjustment to Net Income

Net income as disclosed by return	$13,674.46
Additional income: (a) Partnership income	12,753.03
Net income adjusted	$26,427.49

Explanation of Adjustment

(a) Income from partnership of Choate and Choate and Chioate reported in the amount of $13,674.46 increased by $12,753.03 to $26,427.49 to include in gross income your [fols. 9-17] distributable portion of the corrected net income of the partnership, as shown by report covering examination of the partnership, a copy of which report has been furnished the partnership. The adjustment is shown as follows:

	Partnership Income		
	Reported	Corrected	Adjustment
Ordinary income	None	$22,047.57	$22,047.57
Ordinary loss	$(2,784.11)	none	2,784.11
Long-term capital gain	11,978.48	none	(11,978.48
Short-term capital gain	4,480.09	4,379.92	(100.17)
Total	$13,674.46	$26,427.49	$12,753.03

Computation of Tax

Net income adjusted	$26,427.49
Less: Personal exemption	2,500.00
Balance (Surtax net income)	$23,927.49
Less: Earned income credit (10% of $3,000.00)	300.00
Net income subject to normal tax	$23,627.49
Normal tax at 4% on $23,627.49	945.10
Surtax on $23,927.49	1,887.67
Correct income tax liability	$2,832.77
Income tax assessed, account #200801	817.19
Deficiency of income tax	$ 2,015.58

• • • • • • •

[fol. 18] EXHIBIT "D" TO AMENDED PETITION

Assignment of Oil and Gas Lease, L. H. Choate and Fred T. Hogan to Sylva Oil Company

THE STATE OF TEXAS,
County of Upton:

Whereas, on the 8th day of September, 1924, a certain oil and gas mining lease was made and entered into by and between Mrs. M. L. Baker (nee Greenwade), as Lessor, and G. A. Tunstill, as Lessee, covering among other lands, the following described lands in Upton County, Texas, to-wit:

A portion of Survey No. 7, in Block "R" certificate No. 563, Confd, Scrip. to M. S. Denton, described by metes and bounds as follows:

Beginning at a stake, the east corner of a survey of 1280 acres in the name of E. C. Grooms, same being the North corner of survey No. 7, Block "R", M. S. Denton; thence S. 50 deg. E 1124.4 varas to the most northerly southeast corner of this tract; thence 40 deg. W 237.6 varas to the most easterly inside corner of this tract; thence S 50 deg. [fol. 19] E 237.6 varas to the most southerly southeast corner of this tract; thence S 40 deg. W 418.4 varas to the east corner of a tract of land containing 80 acres assigned by Continental to Chas. L. Morgan by instrument dated November 13, 1925; thence N 50 deg. W with the NE B. L. of said Morgan tract 672 varas to its north corner; thence S 40 deg. W with the NW B. L. of said Morgan tract 672 varas to its west corner; thence N 50 deg. W 688 varas to a point in the NW B. L. of Survey No. 7, Block "R" M. S. Denton, the most westerly corner of this tract; thence N 40 deg. E 1328 varas with the NW B. L. of said Survey No. 7 to the place of beginning, containing 230 acres of land, more or less,

said lease being of record in Vol. 18, pp. 523-527 of the Oil and Gas Lease records of said county, and having been executed in lieu of and for the purpose of correcting, that certain oil and gas lease made and entered into by and between the said Mrs. M. L. Baker and her husband, J. Holmes Baker, bearing the same date and recorded in Vol. 17, p. 43, of the Oil and Gas Lease Records of said county; and

Whereas, said lease and all rights thereunder, in so far as same covers the above specifically described land, was assigned to Roy R. Brown by Continental Oil Company by instrument dated December 3, 1936, recorded in Volume 50, page 381, of the deed records of Upton County, Texas, such assignment being of all oil and gas rights down to the depth of 2750 feet from the surface (all oil, gas and casinghead gas, and the oil, gas and casinghead rights, below said depth of 2750 feet being specifically reserved by the Continental Oil Company) and the Continental Oil Company expressly reserving in said instrument 1/16 of all of the oil, gas or casinghead gas produced, saved and sold, from said specifically described land from depths not exceeding 2750 feet from the surface; which said assignment and its record are here now referred to and made a part hereof for all purposes;

And whereas, said lease and all rights thereunder, in [fol. 20] so far as same covers the above specifically described land and down to the depth of 2750 feet from the surface and subject to the terms and conditions and the said reservation of 1/16th overriding royalty in said assignment from the Continental Oil Company to Roy R. Brown, hereinbefore referred to, are now owned by L. H. Choate and Fred T. Hogan.

Now, therefore, for and in consideration of One Dollar ($1.00) and other good and valuable considerations, the receipt of which is hereby acknowledged, the undersigned L. H. Choate and Fred T. Hogan, the present owners of said lease, as hereinabove set out, and all rights thereunder or incident thereto down to the depth of 2750 feet, subject to all the terms and conditions and the said reservation of 1/16 overriding royalty in said assignment from the Continental Oil Company to Roy R. Brown, do hereby bargain, sell, assign and convey, subject to all of the terms and conditions, and the reservation of 1/16th overriding royalty in said asignment from Continental Oil Company to Roy R. Brown, all right, title and interest of the original lessee and the present owner in and to said lease, and rights thereunder or incident thereto, in so far as the same covers and affects the oil gas and casinghead gas, and the oil, gas and casing gas rights, at *an* above the depth of two thousand seven hundred fifty feet from the surface in and under the said 230 acres of land above described,

together with all wells and the equipment thereof, including pumps, casing, piping, tanks, lease house, and all other personal property on or used in connection with said premises, including oil in storage to Sylva Oil Company, a Texas corporation, its successors and assigns; save and except that assignors herein expressly reserve to themselves, their heirs and assigns, and do not assign or convey to the assignee herein, 1/8 of 8/8ths of all oil and gas and casinghead gas which may be produced and saved by Sylva Oil Company, its successors and assigns, from the aforesaid land at and above the depth of two thousand seven hundred and fifty feet from the surface under and by virtue of the lease above mentioned, delivery of such part of the oil, gas and casinghead gas to be made free of cost [fol. 21] to the assignors in the storage tanks by them provided on said property or into the pipe line to which the wells on said premises may be connected; such reservation of overriding royalty or share of production to be 1/16th of the 8/8ths in favor of L. H. Choate and 1/16th of the 8/8ths in favor of Fred T. Hogan.

It being, however, expressly understood and agreed by and between the parties hereto that assignee shall, with reasonable diligence, being the drilling of a well prospecting for oil and gas on some part of said property and will drill the same with due diligence to completion and further, that said assignee will continue the drilling of said property, after the drilling of said first well, with due and reasonable diligence, until such time as the property is reasonably developed; the obligation on assignee to so drill such property being subject only to such valid spacing and proration rules and regulations as may be imposed by the proper authorities, and to conditions happening or becoming known which would cause a reasonably prudent operator to refrain for the time being or indefinitely from drilling additional wells.

It being further understood and agreed that if assignee herein, its successors and assigns, should decide at any time to abandon or sell any well or wells, less than the whole number of wells on the premises, the production from which has been seriously depleted, which said well or wells have been drilled on said lease, assignors herein, their heirs, successors or assigns, shall have the option to purchase such well or wells at the highest bona fide offer

that assignee may have received for the same; any such well or wells to carry with it ten (10) acres in the form of a square (as nearly as practicable) around each well. Assignors, their heirs and assigns, will be required to exercise their right to purchase such well or wells under such conditions within five (5) days after the opportunity is given them to so purchase the same.

And for the same considerations, the undersigned for themselves, their heirs, successors and assigns, do covenant with the said assignee, its successors or assigns, that they [fol. 22] are the lawful owners of the said lease down to the depth of 2750 feet from the surface and the rights and interests thereunder, but subject to all of the terms, conditions, reservations and limitations set out in said contract of assignment from the Continental Oil Company to Roy R. Brown, above mentioned, and are the lawful owners of all the wells and the equipment thereof, including pumps, casing, piping, tanks, lease house, and all other personal property on or used in connection with such premises, including oil in storage; that they have good right and authority to sell and convey the same and that the herein conveyed rights, interests and property are free and clear from all liens and incumbrances, and that all rentals and royalties due and payable thereunder have been duly paid, and that all terms and conditions of said assignment from Continental Oil Company to Roy R. Brown, and of the assignment from Roy R. Brown to the assignors herein, have been fully performed to date, and that the undersigned will warrant and defend the title herein conveyed (which as aforesaid, does not include the 1/16th overriding royalty reserved in that certain contract of assign-ent from the Continental Oil Company to Roy R. Brown, hereinabove mentioned, or the 1/8th overriding royalty herein reserved by assignors) against the lawful claims or demands of all persons whomsoever.

This assignment shall be effective as of date August 15, 1938, at 7:00 A. M. For purpose of division between assignors and assignee, 12/27ths of the production from said lease for the month of August 1938, shall be attributed to the period prior to 7:00 A. M., August 15th, 1938, and 15/27ths of the production for August 1938, shall be attributed to the period after said hour and date.

Assignors will pay all taxes for the year 1938, and assignee will reimburse assignors for 3/8ths of the amount hereof.

This instrument is also executed by Sylva Oil Company as an indication of its acceptance of all the terms and conditions hereof.

[fol. 23] Executed this the 22 day of August, A. D. 1938.

L. H. Choate, Fred T. Hogan, Assignors. Sylva Oil Company. By J. G. Puterbaugh, President. Assignee. (Seal.)

Approved:

Locke, Locke, Stroud and Randolph, Attys.

The State of Texas,
County of Midland:

Before me, the undersigned, a Notary Public in and for said county and state, on this day personally appeared L. H. Choate and Fred T. Hogan, known to me to be the persons whose names are subscribed to the foregoing instrument and acknowledged to me that they each executed the same for the purposes and conditions therein expressed.

Given under my hand and seal of office this the 22 day of August, A. D. 1938.

Gertrude Harris, Notary Public in and for Midland County, Texas.

The State of Texas,
County of Dallas:

Before me, the undersigned, a Notary Public in and for said County and State, on this day personally appeared J. G. Puterbaugh, known to me to be the person and officer whose name is subscribed to the foregoing instrument and acknowledged to me that the same was the act of the said Sylva Oil Company, a Texas corporation, and that he executed the same as the act of such corporation for the purposes and consideration therein expressed, and in the capacity therein stated.

Given under my hand and seal of office this the 22 day of August, A. D. 1938.

Gertrude Harris, Notary Public in and for Dallas County, Texas.

[fol. 24] IN THE TAX COURT OF THE UNITED STATES

EXCERPT FROM TRANSCRIPT OF TESTIMONY

ANSWER TO AMENDED PETITION READ INTO THE RECORD

Mr. Schlosser: In answer to the amended petitions, filed in the cases of Fred T. Hogan, L. H. Choate, Lucille Choate and Dr. W. G. Choate, the respondent denies that he erred in the manner alleged in sub-paragraph (a) to (e) inclusive, in paragraph IV in the petition.

As to this paragraph V, of each of the amended petitions the commissioner denies the allegations thereof, with the exception that it is admitted that the commissioner determined that Choate and Hogan realized a net ordinary gain of $76,750.00 from the Baker lease transaction, and that Fred Hogan owned a fifty percent interest in the Choate and Hogan partnership, as alleged in sub-paragraph (a) and (b); in sub-paragraph (e) the commissioner denies the allegations contained in that sub-paragraph.

As to the sub-paragraph (d) of paragraph V of the amended petitions in each case, the respondent denies the allegations contained therein, with the exception that it is admitted that during the year 1938, Fred T. and Novadean Hogan made a sale of the Sanger lease.

Respondent denies each and every material allegation not heretofore specifically admitted or denied in each amended petition.

Filed May 16, 1942.

IN THE TAX COURT OF THE UNITED STATES

Docket Nos. 107630, 107631, 107886, 107887, 107888

James H. Yeatman, Esq., and Claude Collard, C. P. A., for the petitioners. Frank B. Schlosser, Esq., for the respondent.

MEMORANDUM FINDINGS OF FACT AND OPINION—Dec. 9, 1942

OPPER, J.:

These consolidated proceedings challenge income tax deficiencies determined by respondent for the year 1938 as follows:

[fol. 25] Fred T. Hogan	$3,671.81
Nevadena Hogan	12.21

L. H. *Choste*	632.85
Lucille Choate	632.85
W. G. Choate	$2,015.58

The questions presented are (1) whether a transaction involving an oil and gas lease gave rise to capital gain or ordinary income, (2) the proper treatment for purposes of depreciation of the equipment on the lease, and (3) whether the taxable income arising out of the assignment of the lease and attributable to the interest of petitioner Fred T. Hogan is his separate income or community income to be divided between Fred T. Hogan and petitioner Novadean Hogan.

Petitioners Fred T. Hogan and Novadean Hogan abandoned error charged with respect to gain arising from the sale of another lease by them.

Findings of Fact

All the stipulated facts are hereby found accordingly. From the evidence adduced at the hearing further facts are found and those facts in the following recital, which are not from the stipulation, are found from the evidence adduced at the hearing.

Petitioners are all individuals. Lucille Choate is the wife of L. H. Choate and during the years 1936, 1937, and 1938, they were living together in Texas as husband and wife. Novadean Hogan is the wife of Fred T. Hogan. With the exception of W. G. Choate, the Federal tax returns for each of the petitioners for the year 1936 were filed with the collector of internal revenue at Dallas, Texas. W. G. Choate's return for 1936 was filed with the collector of internal revenue at Oklahoma City, Oklahoma.

On September 8, 1924, Mrs. N. L. Baker executed an oil and gas lease to C. A. Tunstill, covering, among other land, 230 acres located in Upton County, Texas. Under the terms of the lease the lessee had 10 years in which to produce oil or gas; on the production of oil or gas the term of the [fol. 26] lease was to be 50 years from the date of its execution. The lessor retained the customary one-eighth *roy* royalty interest, and was entitled to receive delay rentals on the lessee's failure to begin drilling operations within 12 months from the date of the *executuin* of the lease.

On July 7, 1925, Tunstill assigned the lease to the Marland Oil Company and on July 1, 1929, the lease became the property of the Continental Oil Company as the result of a consolidation of the two companies.

By an instrument dated December 3, 1936, the Continental Oil Company assigned to Roy R. Brown all its right, title, and interest in the lease in question "in so far as said lease covers and affects the oil, gas and *cacinghead* gas, and the oil, gas and *cacinghead* gas rights, at and above the *dept* of 2,750 feet from the surface in and under" the 230 acres. Brown assumed all the covenants of the original lease and further agreed that "as a part of the consideration for this assignment, the assignor shall receive, as an overriding royalty, one-sixteenth (1/16th) of all the oil, gas or *cacinghead* gas produced, saved and sold from the * * * land, from depths not exceeding 2750 feet from the surface." This lease will sometimes hereinafter be referred to as the Baker lease.

On December 18, 1936, petitioners Fred T. Hogan and L. H. Choate acquired Brown's interest in the Baker lease by assignment for a consideration of $5,000, $2,500, of which was to be paid in cash and the remaining $2,500 was payable out of one-eighth of the thirteen-sixteenths of all oil produced and saved from the property if, as, and when produced.

Fred T. Hogan and L. H. Choate, in acquiring the interest in the Baker lease from Brown were acting for themselves and W. G. Choate. After acquiring the interest in the Baker lease Hogan and L. H. Choate proceeded to organize a partnership known as "Choate & Hogan" of Midland, Texas, to own, develop and operate the Baker lease. The profits and losses of the partnerships were to be shared 50 per cent by Hogan and 50 per cent by L. H. Choate and W. G. Choate.

[fol. 27] In the conduct of the affairs of the partnership, Hogan had supervision of the geological work in connection with the drilling of the wells; he also attended to financial arrangements, the sales of oil produced from the lease and negotiated the sale of the lease itself. L. H. Choate was a drilling contractor who used his own equipment in drilling the wells on the lease. Hogan was dependent upon L. H. *Choat* for the drilling of the wells. This was the

reason for the formation of this partnership. W. G. Choate was a partner of L. H. Choate and performed no services on the lease.

In developing and operating the Baker lease the partnership drilled six wells. In order to finance the drilling of the wells they obtained loans from the Mercantile National Bank of Dallas, Texas, as follows:

Due Date	Description	Amount
6-15-37	Note #1, Baker Wells #1 and #2	$21,666.67
9- 2-37	Note #3, Baker Well #3	11,000.00
10- 7-37	Note #4, Baker Well #4	11,000.00
11- 6-37	Note #5, Baker Well #5	11,000.00
12- 4-37	Note #6, Baker Well #6	11,000.00
	Total Principal Sum	$65,666.67

The agreement under which these loans were made provided that the indebtedness should be liquidated from an assignment of oil runs from the Baker lease and the indebtedness was paid therefrom to the extent of $36,256.30. The balance of the indebtedness of $65,666.67 was paid on August 22, 1938, not out of oil runs but, in effect, out of the proceeds received by the partnership from the conveyance of an interest in the Baker lease to the Sylva Oil Company, to be *described* presently.

The Baker lease was owned and operated by the partnership until that conveyance which took place on August 22, 1938.

On August 11, 1938, the partnership entered into a written contract covering the Baker lease to the McAlester Fuel Company in which the partnership was designated as "seller" and the McAlester Fuel Company as "buyer". Under the contract the partnership was to execute and [fol. 28] deliver an assignment of the lease to the McAlester Fuel Company and that company was to "buy" the lease from the partnership for a consideration of $110,000 in cash, to be paid upon delivery of a proper assignment of the lease to the McAlester Fuel Company. The partnership was "to except and reserve to themselves, their heirs and assigns, an overriding royalty of 1/8th of 8/8ths of all oil and gas produced" by the McAlester Fuel

Company, its successors or assigns. The reservation was to be one-sixteenth in the name of L. H. Choate and one-sixteenth in the name of Hogan.

By agreement between the parties the contract of purchase of the lease was to be carried out by execution of an instrument of conveyance to the Sylva Oil Company instead of to the McAlester Fuel Company.

On August 22, 1938, the Sylva Oil Company notified L. H. Choate that it had purchased the lease "together with the producing oil wells thereon and the equipment of such wells, including the house on the lease." This letter farther advised that it was understood that L. H. Choate had on the lease certain drilling equipment, pipe and a pick-up truck which it was choate's privilege to remove since the Sylva Oil Company was "only acquiring the personal property actually used and attached to such producing wells on the lease," and the above-mentioned house.

On the same date, August 22, 1936, Choate & Hogan executed an instrument by which they did "bargain, sell, assign and convey" the Baker lease subject to all the terms of the instrument under which it was acquired by the partnership, all of its right, title and interest in the property "together with all wells and the equipment thereof, including pumps, casing, piping, tanks, lease house, and all other personal property on or used in connection with said premises, including oil in storage, to Sylva Oil Company, a Texas corporation, its successors and assigns; save and except that assignor herein expressly reserve to themselves, their heirs and assigns, and do not assign or convey to the assignee herein, 1/8 of the 8/8ths of all oil and gas and casinghead gas which may be produced and saved by [fol. 29] Sylva Oil Company its successors and assigns, from the aforesaid land at and above the depth of two thousand seven hundred fifty feet from the surface under and by virtue of the lease above mentioned, delivery of such part of the oil, gas and casinghead gas to be made free of cost to the assignors * * *; such reservation of overriding royalty or share of production to be 1/16th of the 8/8ths in favor of L. H. Choate, and 1/16th of the 8/8ths in favor of Fred T. Hogan."

At the date of the transaction with Sylva Oil Company the interest in the Baker lease owned by Choate and Hogan

consisted of thirteen-sixteenths of eight-eighths, the $2,500 oil payment reserved by Roy R. Brown having been paid out during March, 1938, and the cost, less depletion sustained, of this interest to the partnership was $23,583.78 on that date.

On the date of the transaction the cost of the equipment on the lease, less depreciation sustained, was $23,090.60.

After the *assignment*, Sylva Oil Company drilled and paid for four additional oil wells and operated the lease, and the parties otherwise conformed to the terms of the instrument. Neither the Choates nor Hogan understood that they had any rights as landlord. Sylva Oil Company certified and guaranteed to Humble Oil Company that effective 7:00 A. M. on August 15, 1938 (the effective date of the last transaction) it was the legal owner of a seven-eighths interest in the oil produced from the property covered by the Baker lease subject to overriding royalties of one-sixteenth each to Continental, L. H. Choate and Hogan.

Sylva Oil Company allocated the $110,000 purchase price as follows:

Leasehold costs, $46,500; equipment of six wells, $24,000; additional equipment and gun barrel, $2,500; drilling cost of six wells, $36,000; dwelling on the lease, $1,000. It claimed depreciation on the cost thus allocated to equipment in its return for the year 1938 in the amount of $1,674.17 and in its income tax return for 1939 in the amount of $5,613.35 which amounts were allowed to it for those [fol. 30] years as depreciation on the equipment by the Commissioner of Internal Revenue after an examination by his agent. Sylva Oil Company assessed the leasehold interest which it acquired and all the equipment thereon for ad valorem taxes in the State of Texas and County of Upton and paid the taxes based on such assessment. Sylva Oil Company also made all repairs and replacements to the equipment after August 22, 1938, and paid for all such repairs and replacements.

The transaction involved was reported in the partnership return of Choate and Hogan for the year 1938 as a sale as follows:

	Leasehold	Equipment	Total
Sale Price	$98,454.70	$11,545.30	$110,000.00
Less Cost of Sale:			
Gross Cost	$33,391.80	$30,206.49	$63,598.29
Less-Reserves for Depletion and Depreciation	9,808.02	7,115.89	16,923.91
Net Cost of Sale	$23,583.78	$23,090.60	$46,574.38
Gross Gain from Sale	$74,870.92	($11,545.30)	$63,325.62
Less Commission Paid	3,000.00		3,000.00
Net Gain from Sale	$71,870.92	($11,545.30)	$60,325.62
Taxable Gain from Sale (Sec. 117. Revenue Act of 1938)	$47,913.95	($11,545.30)	$36,368.65

The loss of $11,545.30 as above computed on the sale of equipment was reported as an ordinary loss. The net gain from the sale of the leasehold of $71,870.92 was reported as a long-term capital gain, under section 117, Revenue Act of 1938, taxable to the extent of $47,913.95.

The above gain of $47,913.95 and loss of $11,545.30 were reported in the individual returns of the partners as follows:

[fol. 31]		Gain	Loss
Fred T. Hogan	1/2	$23,956.98	$ 5,772.65
Novadean Hogan		None	None
L. H. Choate	1/8	5,989.24	1,443.16
Lucille Choate	1/8	5,989.24	1,443.16
W. G. Choate	1/4	11,978.49	2,836.33
		$47,913.95	$11,545.30

In his notice of deficiency respondent determined that the partnership did not make a sale of the Baker lease but held that the transaction constituted a sublease, the

consideration of $110,000 being a bonus. Respondent computed the gain on the transaction as follows:

Oil Income		$110,000.00
Less—Depletion	$30,250.00	
Commissions	3,000.00	33,250.00
		$ 76,750.00

Fred T. Hogan and Novadean Hogan were married in Arizona on September 6, 1937, and from the date to the present time have lived together as husband and wife in Texas. At the time of their marriage three wells had been drilled by the partnership on the lease and prior to the time the lease was sold to the Sylva Oil Company three additional wells were drilled. As heretofore indicated, Hogan did the geological work together with general management and arranged for financing and for the ultimate sale of the lease. Prior to their marriage Novadean worked for the partnership in its office at Midland, Texas. She handled the correspondence and prepared monthly reports required by the railroad commission and others. She performed the general office work in connection with the acquisition, development and operation of the lease by the partnership. After their marriage she continued to perform these duties and was paid a salary by the partnership. She also did work for L. H. Choate in connection with drilling for outsiders for which she was not paid any additional salary.

[fol. 32] The cost of the wells incurred by the partnership allocated to the periods before and after marriage were as follows:

Before marriage	$25,762.03
After marriage	39,141.80
Total	$64,903.83

Runs from the Baker lease were to be paid over to the bank and applied on the indebtedness. An assignment of such oil runs was given by the partnership to the bank. The oil runs from the lease used to apply on the indebtedness, segregated between production before and after marriage were as follows:

Before marriage	$ 1,056.85
After marriage	$35,199.45
Total	$36,256.30

Total production from the interest in the Baker lease owned by the partnership during the period of ownership *amounted* to $39,265.50, being $4,066.05 from production before the marriage and $35,199.45 after the marriage.

OPINION

That petitioners were not entitled to treat the transfer of an interest in these leases as a sale, but must look to depletion for the return of their capital, is sufficiently clear to require but little demonstration. Where a royalty *interest* is retained, as was the case here, the *principle* of recovery by depletion rather than by treatment as a sale applies to all receipts, including any cash bonus which is regarded as in the nature of advance royalties. Cullen v. Commissioner (C.C.A., 5th Cir.), 118 Fed. (2d) 651; McLean v. Commissioner (C.C.A., 5th Cir.) 120 Fed. (2d) 942.

The authority of these cases has not been weakened by Le v. Commissioner (C.C.A., 5th Cir.), 126 Fed. (2d) 825. Its effect was merely to repudiate the distinction originally drawn in Commissioner v. Laird. (C.C.A., 5th Cir.), 91 Fed. (2d) 498, between royalty and oil-payment cases as to recovery of initial cost. If this were an oil payment case which it is not, and if the *Lee* case had not been decided, [fol. 33] petitioners might be in a position to seek to limit the taxability of the cash received to the excess over their original investment on the theory of the Laird case. Cf. Columbia Oil and Gas Co. v. Commissioner (C. C. A., 5th Cir.) 118 Fed (2d) 459. But we are at a loss to see that petitioners can take any comfort from the *Lee* case under the circumstances existing here. This issue is decided for respondent.

What gives us the greatest difficulty is a sentance in Cullen v. Commissioner, supra, to the effect that "the cost of equipment * * * may be recovered by percentage depletion allowance." It is by no means clear that the court intended there to hold that tangible physical equip-

ment used in the operation of leases transferred upon a retained royalty was subject to recovery through depletion rather than through depreciation on the one hand or from the proceeds of the sale on the other. Even, however, if that were the intention, the present facts are distinguishable from those in the Cullen case. The contracts there made no mention of the physical equipment, and it might have been assumed that the transfer intended to retain the tangible property or an interest therein, at least to the same extent as with respect to the oil itself.

Here the assignment not only contained specific reference to the tangible equipment but seems to require the construction that all of petitioner's interest for all time and for all purposes was thereby transferred to the assignee. Cf. Columbia Oil and Gas Co. v. Commissioner, supra. If that is the proper construction of the contract, petitioner would have no further claim to depreciation on the equipment, cf. Regulations 101, Article 23, (a) 18, and its unrecovered cost could be secured only by allocating to the equipment some portion of the purchase price, which the petitioners here seem to have done or, in the alternative, by deducting the difference as a loss. Without being assured as to the meaning of the quotation from the Cullen case, we are nevertheless satisfied that it is in any event inapplicable here, and conclude that petitioners are entitled to an allowance for the unrecovered cost of the equipment transferred.

[fol. 34] The final issue with respect to petitioner, Fred T. Hogan, involves the claim that the proceeds of the assignment were community income. The leases in question were acquired prior to his marriage, and it must be recognized that ordinarily the proceeds of such a transaction as we have here would be regarded as an increase in lands owned by petitioner prior to his marriage, and hence his separate income. Commissioner v. Wilson (C. C. A., 5th Cir.), 76 Fed. (2d) 766; Turhaville v. Commissioner. (C. C. A., 5th Cir.), 84 Fed. (2) 307.

It is asserted, however, that in this instance the profit was made possible by the intermediate development of the oil property which took place to a preponderant extent subsequent to the marriage; and further, that some of the income from the lease, admittedly belonging to the community, was used to finance such development. We

are not convinced that either consideration is sufficient to authorize an exception in this case. The interest which was transferred and for which the payment was received was in the leases themselves. It was not compensation for the services of the husband. Nor is it clear that his personal activities in designating the location of the wells, as distinguished from the actual drilling which was performed by others, added materially to the value of the property. See Commissioner v. Turbeville, supra. And certainly, the use of community funds with or without the approval of the wife could do no more than possibly create an indebtedness. None of the considerations advanced by petitioner were sufficient to transform separate property into community income. E. Michas, 24 B. T. A. 715.

Decision will be entered under Rule 50.

Entered: December 9, 1942.

In the Tax Court of the United States

Decision—Feb. 12, 1943

Respondent having on January 5, 1943, filed a computation as in accordance with the memorandum findings of fact and opinion of the Court, entered herein December 9, 1942, and petitioner having on January 30, 1943, filed a recomputation in opposition thereto, and this proceed-[fol. 35] ing having been called from the Day Calendar for hearing on February 10, 1943, at Washington, D. C., pursuant to notice, at which time respondent agreed to petitioner's computation, now, therefore, it is

Ordered and decided: That there is a deficiency in income tax for the year 1938 in the amount of $1,052.07.

Clarence V. Opper, Judge. (Seal.)

Enter:

Entered February 12, 1943.

In United States Circuit Court of Appeals

Petition for Review—Filed May 1, 1943

To the Honorable Judges of Said Court:

Now comes the petitioner, W. G. Choate, by his attorney, James H. Yeatman (Vinson, Elkins, Weems & Francis)

and files this his petition for review by the United States Circuit Court of Appeals for the Tenth Circuit of the decision of the Tax Court of the United States entered February 12, 1943.

Jurisdiction

The petitioner is an individual and his residence and place of business is at Cisco, Texas. Petitioner's return for the calendar year 1938, the year in controversy, was filed with the Collector of Internal Revenue at Oklahoma City, Oklahoma, which is within the Tenth Judicial District of the United States. On March 20, 1941, the respondent in accordance with Section 272 (a) of the Internal Revenue Code, advised the petitioner by registered mail that a determination of his income tax liability for the year ended December 31, 1938, disclosed a deficiency of $2,015.58. Thereafter the petitioner duly filed with the then United States Board of Tax Appeals (now the Tax Court of the United States) a petition for redetermination of the deficiency disclosed in the respondent's said letter of March 20, 1941, and respondent duly filed an answer to the said petition. The proceeding was heard by the United States Board of Tax Appeals on May 5, 1942, and was submitted on a stipulation of facts, documentary evidence and oral [fol. 36] testimony. On February 12, 1943, the Tax Court of the United States entered its decision that there is a deficiency in petitioner's income tax liability for the calendar year 1938 in the amount of $1,052.07. The jurisdiction of this Court is invoked under Section 1141 of the Internal Revenue Code.

Nature of the Controversy

The controversy between the parties is whether certain income received by petitioner was gain from the sale or exchange of a capital asset. The facts are that on December 18, 1936, Fred T. Hogan acting for himself and L. H. Choate and W. G. Choate purchased an oil and gas lease from Roy R. Brown. Said lease was known as the Baker lease and covered a tract of land located in Upton County, Texas. Immediately after said lease was acquired a partnership known as Choate & Hogan was formed to own, develop and operate it and it was agreed that the profits and losses of the partnership would be shared 50% by petitioner and L. H. Choate and 50% by Fred T. Hogan. The part-

nership developed the Baker lease by drilling six producing oil wells thereon and operated it until August 22, 1938. On August 11, 1938, L. H. Choate and Fred T. Hogan acting for the partnership entered into a written contract to sell the Baker lease, together with all of the equipment thereon, to the McAlester Fuel Company. The consideration to be paid by the McAlester Fuel Company was $110,000.00 in cash and the sellers were to except and reserve to themselves an overriding royalty of one-eighth. Said contract was consummated and carried out according to its terms by L. H. Choate and Fred T. Hogan on August 22, 1938, executing an assignment of the lease to the Sylva Oil Company, nominee of the McAlester Fuel Company, and the Sylva Oil Company paying the agreed consideration of $110,000.00. The petitioner unsuccessfully contended before the Court below that an interest in the Baker lease was sold to the Sylva Oil Company and that the net proceeds derived from the sale was taxable as long-term capital gain under Section 117 of the Code. With respect to the leasehold itself the Court below held that the transaction was a sublease of the lease rather than a sale; that the consideration received therefor was a bonus, [fol. 37] subject to the allowance for depletion, and not gain derived from the sale or exchange of capital asset.

Designation of Court of Review

The petitioner being aggrieved by the conclusions of law contained in the opinion of the Tax Court of the United States in its memorandum opinion promulgated December 9, 1942, and by the final decision entered by it on February 12, 1943, pursuant to said opinion, desires to obtain a review thereof by the United States Circuit Court of Appeals for the Tenth Circuit.

Assignments of Error

The petitioner's assignments of error are as follows:

I

The Tax Court of the United States erred in failing to find and decide that petitioner and his co-owners sold to the Sylva Oil Company all of their interest in the Baker leasehold estate save and except the one-eighth overriding

royalty retained and in failing to find and decide that the profit realized on the transaction was gain from the sale or exchange of a capital asset within the meaning of Section 117 of the Internal Revenue Code.

II

The Tax Court of the United States erred in finding and deciding that petitioner and his co-owners subleased their Baker leasehold estate to the Sylva Oil Company and in finding and deciding that the transaction with the Sylva Oil Company was not a sale of a capital asset within the purview of Section 117 of the Internal Revenue Code.

Wherefore, petitioner prays that this Honorable Court may review said findings, opinion and decision of the Tax Court of the United States and set aside same in so far as it was held therein that petitioner and his co-owners did not sell an interest in the Baker leasehold estate and that the gain realized thereon was not gain from the sale or exchange of a capital asset and that this Court direct entry of a decision by the said Tax Court of the United States in favor of petitioner on the above said lease.
[fol. 38] Petitioner prays for such relief as he is entitled to receive, and prays that the Clerk of the Tax Court of the United States be directed to transmit and deliver to the Clerk of this Honorable Court certified copies of all documents material for the presentation of the foregoing petition for review as required by the Rules of this Honorable Court and by the statutes made and provided, and petitioner prays for such other and further relief as is mete and proper in the premises.

W. G. Choate, Petitioner, By James H. Yeatman, Counsel for Petitioner, 11th Floor Esperson Bldg., Houston, Texas.

Duly verified by James H. Yeatman.

IN THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE TENTH CIRCUIT

TAXPAYER'S STATEMENT OF POINTS—Filed July 5, 1943

The point relied on by taxpayer is that the transaction whereby the partnership of Choate and Hogan, of which

taxpayer was a member, disposed of an interest in an oil and gas lease, was a sale, and not a sublease, as held by the Tax Court, and that the profit realized thereon was long term capital gain, as defined by Section 11 of the Internal Revenue Code.

James H. Yeatman, Niels Esperson Bldg., Houston, Texas, Attorney for Petitioner on Review.

[fol. 39] In United States Circuit Court of Appeals

Petition for Review—Filed May 3, 1943

Guy T. Helvering, United States Commissioner of Internal Revenue, holding office by virtue of the laws of the United States, hereby petitions the United States Circuit Court of Appeals for the Tenth Circuit to review the decision entered by the Tax Court of the United States on February 12, 1943, that there is a deficiency in income tax for the year 1938 in the amount of $1,052.07. The respondent on review, W. G. Choate, filed his Federal income tax return for the calendar year 1938, the taxable year here involved, with the Collector of Internal Revenue for the District of Oklahoma, whose office is located at Oklahoma City, Oklahoma, and within the judicial circuit of the United States Circuit Court of Appeals for the Tenth Circuit. This petition for review is filed pursuant to the provisions of Sections 1141 and 1142 of the Internal Revenue Code.

Samuel O. Clark, Jr., Assistant Attorney General; J. P. Wenchel, RLW, Chief Counsel, Bureau of Internal Revenue.

In the United States Circuit Court of Appeals

Commissioner's Statement of Points—Filed July 6, 1943

Now comes Guy T. Helvering, Commissioner of Internal Revenue, the petitioner on review herein, by and through his attorneys, Samuel O. Clark, Jr., Assistant Attorney General, and J. P. Wenchel, Chief Counsel, Bureau of Internal Revenue, and hereby states that he intends to rely upon the following points in this proceeding:

The Tax Court of the United States erred:

1. In ordering and deciding that there is a deficiency in income tax for the year 1938 in the amount of only $1,052.07.

2. In failing and refusing to sustain the deficiency in tax determined by the Commissioner.

3. In holding and deciding that in the determination of the profit or loss from the transfer of the taxpayer's inter- [fol. 40] est in the Baker oil and gas lease, the taxpayer is entitled "to an allowance for the unrecovered cost of the equipment transferred," in the taxable year 1938.

4. In failing and refusing to hold and decide that in the determination of the profit or loss from the transfer of the taxpayer's interest in the Baker oil and gas lease in the taxable year 1938, the taxpayer is not entitled to deduct the undepreciated cost of the equipment from the cash proceeds received upon the conveyance of such interest.

5. In failing and refusing to hold and decide that in the determination of the profit or loss from the transfer of the taxpayer's interest in the Baker oil and gas lease in the taxable year 1938, the undepreciated cost of the equipment should be recovered, for income tax purposes, through depletion allowances in the same manner as it (The Tax Court) held that the unrecovered leasehold cost should be recovered.

6. In failing and refusing to hold and decide that where, as in the present case, a leasehold interest is transferred and conveyed for a cash bonus and a retained royalty interest, the taxpayer's unrecovered capital investment in the leasehold so transferred and in the tangible physical equipment thereon should both be recovered through depletion allowances.

7. In that its holding and decision that in the determination of the profit or loss from the transfer of the taxpayer's interest in the Baker oil and gas lease, the taxpayer is entitled "to an allowance for the unrecovered cost of the equipment transferred" to be deducted from the cash bonus is not supported by but is contrary to the facts as found by the Tax Court.

8. In that its holding and decision that in the determination of the profit or loss from the transfer of the taxpayer's interest in the Baker oil and gas lease, the taxpayer is entitled "to an allowance for the unrecovered cost of the [fol. 41] equipment transferred" to be deducted from the

cash bonus is not supported by the evidence and is contrary to law.

Samuel O. Clark, Jr., C A R, Assistant Attorney General; J. P. Wenchel, CAR, Chief Counsel, Bureau of Internal Revenue.

Statement of Service:

A copy of this statement of points was mailed to James H. Yeatman, Esq., Niels Esperson Bldg., Houston, Texas, attorney for respondent on review this date, July 6, 1943.

Chas. E. Lowery, Special Attorney.

IN THE TAX COURT OF THE UNITED STATES

ORDER ENLARGING TIME TO DOCKET PETITION

Upon motion of counsel for petitioner, it is

Ordered: that the time for preparation, transmission and delivery of the record sur petition for review of the above-entitled proceeding in the United States Circuit Court of Appeals for the Tenth Circuit is extended to July 30, 1943.

J. E. Murdock, Presiding Judge.

Dated: Washington, D. C., June 7, 1943.

Filed July 29, 1943. Robert B. Cartwright, Clerk.

Clerk's Certificate to foregoing order omitted in printing.

[fol. 42] IN THE TAX COURT OF THE UNITED STATES

ORDER ENLARGING TIME TO DOCKET PETITION

Upon motion of counsel for petitioner, it is

Ordered: that the time for preparation, transmission and delivery of the record sur petition for review of the above-entitled proceeding in the United States Circuit Court of Appeals for the Tenth Circuit is extended to July 31, 1943.

J. E. Murdock, Presiding Judge.

Dated: Washington, D. C., May 22, 1943.
Filed July 29, 1943. Robert B. Cartwright, Clerk.

Clerk's Certificate to foregoing order omitted in printing.

IN THE TAX COURT OF THE UNITED STATES

AGREED STATEMENT OF FACTS

It is stipulated and agreed by and between the parties hereto, acting through their attorneys, that the above styled proceedings may be consolidated for the purpose of hearing, and it is further stipulated and agreed that the following facts are true and may be so found by this Board, subject to the right of either party to offer other evidence not inconsistent with the facts so stipulated.

1

All of the Petitioners are individuals. Mrs. Lucille Choate is the wife of L. H. Choate, and during the years 1936, 1937, and 1938 they were living together in Texas as husband and wife. Novadean Hogan is the wife of Fred T. Hogan. Novadean Hogan and Fred T. Hogan were married in the State of Arizona, September 6, 1937, and since such date to the present time they have continuously lived together as husband and wife in the State of Texas. With the exception of that of W. G. Choate, the Federal Income Tax Returns of each of the Petitioners for the year 1938 were filed with the Collector of Internal Revenue at Dallas, [fol. 43] Texas. Dr. W. G. Choate resided in Oklahoma during 1938, and his return for that year was filed with the Collector of Internal Revenue at Oklahoma City, Oklahoma.

2

On December 3, 1936, the Continental Oil Company, of Ponca City, Oklahoma assigned to Roy R. Brown, of Amarillo, Texas, an interest in an oil and gas lease covering approximately 230 acres of land situated in Upton County, Texas. A true copy of this assignment is attached to the petition in each case as Exhibit "B" and is made a part hereof. This lease will be hereinafter referred to as the Baker lease.

3

On December 18, 1936, Petitioners Fred T. Hogan and L. H. Coate, acting for themselves and for Dr. W. G. Choate, acquired an interest in the Baker lease by assignment from Roy R. Brown. A true copy of said assignment is attached to the petition in each case as Exhibit "C."

4

The consideration paid by Choate & Hogan for the interest in the Baker lease was $5000.00, $2500.00 of which was paid in cash and the balance, $2500.00, was payable out of 1/8 of 13/16 of the oil to be produced therefrom, if, as and when produced.

5

After acquiring the interest in the Baker lease, Fred T. Hogan and L. H. Choate proceeded to organize a partnership known as "Choate & Hogan" of Midland, Texas. It was understood and agreed that the partnership of Choate & Hogan would own, develop and operate the Baker lease and that the profits and losses therefrom would be shared as follows:

[fol. 44] 6

L. H. Choate and Dr. W. G. Choate:	50%
Fred T. Hogan:	50%

The partnership of Choate & Hogan thereupon proceeded to develop and operate the Baker lease until August 22, 1938. On August 22, 1938, L. H. Choate and Fred T. Hogan entered into a transaction with the Sylva Oil Company, a Texas corporation. This transaction was evidenced by a written instrument, copy of which is attached to the petition in each case as Exhibit "D" and is made a part hereof. The consideration running from the Sylva

Oil Company to Choate & Hogan on account of said transaction was $110,000.00 cash. At the time this transaction was made there were six producing oil wells on the Baker lease, all of which had been drilled and operated by the partnership of Choate & Hogan.

7

The transaction between L. H. Choate and Fred T. Hogan and the Sylva Oil Company of August 22, 1938, was reported in the partnership return of Choate & Hogan for the year 1938 as a sale, as follows:

	Leasehold	Equipment	Total
Sale Price	$98,454.70	$11.545.30	$110,000.00
Less Cost of Sale:			
Gross Cost	$33,391,80	$30,206.49	$ 63,598.29
Less Reserves for Depletion & Depreciation	9,908.02	7,115.89	16,923.91
Net cost of Sale	$23,583.78	$23,090.60	$ 46,674.38
Gross Gain from Sale	$74,870.92	($11,545.30)	$ 63,325.62
Less Commission Paid	3,000.00		3,000.00
Net Gain from Sale	$71,870.92	($11,545.30)	$ 60,325.62
Taxable Gain from Sale (Section 117, Revenue Act of 1938	$47,913.95*	($11,545.30)	$ 36,368.65

* This was reported as an ordinary loss.

[fol. 45] The above gain of $47,913.95 and the loss of $11,545.30 were reported in the individual returns of the partners as follows:

		Gain	Loss
Fred T. Hogan	½	$23,956.98	$ 5,772.65
Novadean Hogan		None	None
L. H. Choate	⅛	5,989.24	1,443.16
Lucille Choate	⅛	5,989.24	1,443.16
Dr W. G. Choate	¼	11,978.49	2,836.33
		$47,913.95	$11,545.30

9

It is agreed between the parties hereto that at the date the transaction with Sylva Oil Company occurred the cost, less repletion sustained, of the Baker leasehold-interest to the partnership of Choate & Hogan was $23,583.78 and that the cost of the equipment on the lease, less depreciation sustained, was $23,090.60. If the Board determines that the transaction constitutes a sale of an interest in the Baker leasehold estate, together with the equipment thereon, it is agreed that the profit and loss thereon were correctly reported in the partnership return as indicated in paragraph 7 hereof.

10

In the notice of deficiency on which these proceedings are based, the Respondent determined that Choate & Hogan did not make a sale of the Baker lease. Respondent held that the transaction constituted a sub-lease and that the consideration of $110,000.00 was a bonus and he computed the gain on the transaction as follows:

"Oil Income"		$110,000.00
Less—Depletion	$30,250.00	
Commission	3,000.00	33,250.00
Net Income		$ 76,750.00

[fol. 46] 11

It is agreed that the following statement shows the income from the operation of the Baker lease from April, 1937, to and including August, 1938, and the amounts received by Roy R. Brown on the oil payment reserved:

		Choate & Hogan's Interest		Oil Payment (Roy Brown's Interest)	
		Before Marriage of Fred T. Hogan	After Marriage of Fred T. Hogan	Before Marriage of Fred T. Hogan	After Marriage of Fred T. Hogan
Pipe Line Runs					
1937	April	$ 497.82		$ 71.11	
	May	796.85		113.84	
	June	1,054.81		150.69	
	July	659.72		94.25	
	Aug.	1,056.85		150.93	
	Sept.		$ 1,282.10		$ 183.15
	Oct.		1,571.34		224.48
	Nov.		1,888.54		269.79
	Dec.		2,227.58		318.22
1938					
	Jan.		2,571.08		367.30
	Feb.		2,921.19		417.31
	Mar.		3,532.27		138.88
	Apr.		4,100.64		
	May		4,035.49		
	June		3,621.22		
	July		3,387.74		
	Aug.		4,060.26		
		$4,066.05	$35,199.45	$580.87	$1,919.13

12

In order to finance the development of the Baker lease, the partnership of Choate & Hogan negotiated loans with the Mercantile National Bank of Dallas, Texas, as follows:

[fol. 47]

Due Date	Description	Amount
6-15-37	Note #1, Baker Wells #1 & #2	$21,666.67
9- 2-37	Note #3, Baker Well #3	11,000.00
10- 7-37	Note #4, Baker Well #4	11,000.00
11- 6-37	Note #5, Baker Well #5	11,000.00
12- 4-37	Note #6, Baker Well #6	11,000.00
	Total Principal Sum	$65,666.67
	Add Interest	2,886.06
	Total	$68,552.73

13

The loan agreement with the Mercantile National Bank of Dallas provided that the indebtedness should be liquidated from an assignment of the oil runs from the Baker lease, and, accordingly, such indebtedness was paid as follows: –

Oil Runs Assigned to Bank	Before Marriage of Fred T. Hogan	After Marriage of Fred T. Hogan
1937—August	$1,056.85	$
September		1,282.10
October		1,571.34
November		1,888.54
December		2,227.58
1938—January		2,571.08
February		2,921.19
March		3,532.27
April		4,100.64
May		4,035.49
June		3,621.22
July		3,387.74
August		4,060.28
Totals	$1,056.85	$35,199.45
Balance Paid Aug. 22, 1938		32,296.43
Totals	$1,056.85	$67,495.88

Oil and gas wells were drilled on the Baker lease by the partnership of Choate & Hogan as follows:

Well No.	Completion Date	Cost Marriage Before Fred T. Hogan	After Fred T. Hogan
#1	3- 5-37	$12,238.73	$
#2	4-30-37	13,523.30	
#3	9- 1-37		13,098.49
#4	10- 5-37		8,918.06
#5	11- 1-37		8,573.13
#6	12- 2-37		8,552.12
	Totals	$25,762.03	$39,141.80

James H. Yeatman, Counsel for Petitioners. J. P. Wenchel, JLB, Counsel for Respondent.

* * * * * * *

[fol. 69] PETITIONER'S EXHIBIT 7

Contract

STATE OF TEXAS,
County of Midland:

This Agreement entered into this the 11th day of August A. D. 1938 by and between Choate and Hogan, a co-partnership composed of L. H. Choate and Fred T. Hogan, hereinafter refered to as "Seller" and The McAlester Fuel Company, a Delaware Corporation, hereinafter referred to as "Buyer."

Witnesseth: The said Seller represents that it is the owner of an Oil and Gas Lease covering a part of Survey Number Seven (#7), Block R, Certificate No. 563, Confederate Script, M. S. Denton, Grantee, located in Upton County, Texas, said lands being described by metes and bounds, as follows:

Beginning at a stake, the east corner of a survey of 1280 acres in the name of E. C. Grooms, same being the North corner of Survey No. 7, Block "R", M. S. Denton;

Thence S 50 deg. E 1122.4 varas to the most northerly southeast corner of this tract;

Thence S 40 *deg.* W 257.6 varas to the most easterly inside corner of this tract;

Thence S 50 deg. E 237.6 varas to the most southerly southeast corner of this tract;

Thence S 40 deg. W 418.4 varas to the east corner of a tract of land containing 80 acres assigned by Continental to Chas. L. Morgan by instrument dated November 13, 1925;

Thence N 50 deg. W with the NE B. L. of said Morgan tract 672 varas to its north corner;

Thence S 40 deg. W with the NW B. L. of said Morgan tract 672 varas to its north corner;

Thence N 50 deg. W 688 varas to a point in the NW B. L. of Survey No. 7, Block "R", M. S. Denton, the most westerly corner of this tract;

[fol. 70] Thence N 40 deg. E 1528 varas with the NW B. L. of said Survey No. 7 to place of beginning, containing 230 acres of land, more or less.

Said original lease being recorded in Volume 18, Page 523 of the Oil and Gas Lease Records of Upton County, Texas; said lease held by Seller being by reason of an Assignment from Continental Oil Company, a Delaware Corporation, and down to a depth of 2750' from the surface, all minerals under said depth being reserved by the Continental Oil Company; and the said Continental Oil Company likewise reserved and excepted an overriding royalty of 1/16th of the 8/8ths production, all as shown by such Assignment of Oil and Gas Lease, dated day of , 19 , recorded in Volume , Page of the Deeds Records of Upton County and here now referred to and made a part hereof for all purposes.

The Seller proposes to execute and deliver an Assignment of such Oil and Gas Lease, hereinabove described, to Buyer, subject to the terms and conditions of such Assignment from the Continental Oil Company, and Buyer agrees to buy from Seller such Oil and Gas Lease, all upon the following terms and conditions:

(1) Seller agrees to furnish an Abst*ar*ct of Title certified down to this date, same to be furnished within five (5) days from this date and deliver same to Buyer; Buyer is to have ten (10) days from the date of delivery of such abstract in which to have same examined and to point out objections,

if any there are thereto, in writing; such written objections to be delivered to Seller in Midland, Texas, within said period of ten (10) days; Seller is to have five (5) days after receipt of written objections in which to cure the same and if such objections are not cured within the said period of five (5) days then Buyer is to have five (5) days thereafter in which to accept or reject title in its then condition.

(2) If this deal is consummated and the Assignment delivered, then Buyer is to have all oil runs from and after August 15th, 1938, at 7:00 o'clock A. M., less only actual operating costs after said date, and oil override.

[fol. 71] (3) Seller is to except and reserve to themselves, their heirs and assigns, an overriding royalty of 1/8 of 8/8ths of all oil and gas produced and saved from same by Buyer, its successors or assigns; such reservation in the Assignment to be executed and delivered, to be 1/16th of the 8/8ths in the name of L. H. Choate and 1/16th of the 8/8ths in the name of Fred T. Hogan.

(4) It is further agreed by the parties hereto that in the event of this purchase being completed and proper assignment delivered to Buyer, that Buyer will, with reasonable diligence, begin the drilling of a well, prospecting for oil and gas, on some part of said property and drill same with due and reasonable diligence to completion, and further agrees that it will continue development of said property, after drilling of said first well, with due and reasonable diligence until such time that the property is reasonably developed; the obligation on Buyer to so drill such property is subject only to such valid spacing and proration rules and regulations as may be imposed by the proper authorities, and the future happening of conditions which would cause a reasonably prudent operator to refrain from drilling additional wells.

(5) It is further agreed between the parties hereto that should the Buyer, its successors or assigns, decide at any time to abandon or sell any depleted well, drilled on said lease, that Seller, their heirs, successors or assigns, shall have the refusal to purchase such well at the highest bona fide offer Buyer may have received for the same; any such well to carry with it ten (10) acres around it, in as near the form of a square as practicable. Seller will be required

to exercise their right to purchase well under such conditions within five (5) days after the same is offered.

(6) The consideration to be paid Seller by Buyer is the sum of One Hundred Ten Thousand Dollars ($110,000.00) in cash, upon the delivery of proper assignment of Oil and Gas Lease, conditioned as hereinabove set out and subject to all of the terms and conditions of the contract of assignment from Continental Oil Company, hereinabove referred to.

[fol. 72] (7) Seller represents that it is indebted to The Mercantile National Bank of Dallas, Texas, and that the money necessary to liquidate said debt is to be paid out of the $110,000.00 cash consideration and Buyer is authorized and instructed to pay such amount out of said $110,000.00 which may be necessary to liquidate said indebtedness to The Mercantile National Bank of Dallas, Texas, and a Release of the Lien will be delivered by said bank.

(8) Upon approval and acceptance of title the Seller agrees to execute and deliver to Buyer the proper Assignment of such Oil and Gas Lease as hereinabove provided with express covenants of general warranty;

(9) It is agreed that Buyer is under no obligation to pay any commission to any person by reason of this agreement and transaction, A. W. Cherry being the only agent in the matter and the commission to him is to be paid by Seller.

(10) This Agreement shall extend to and be binding upon the heirs, successors and assigns of the respective parties hereto.

Executed in duplicate this the 11th day of August A. D. 1938.

Choate and Hogan, by L. H. Choate, by Fred T. Hogan, "Seller"; The McAlester Fuel Company, by R. G. Lawton, "Buyer" Agent.

STATE OF TEXAS,
County of Midland:

Before me, the undersigned, a Notary Public in and for said County and State, on this day personally appeared L. H. Choate and Fred T. Hogan, known to me to be the persons whose names are subscribed to the foregoing in-

strument, and acknowledged to me that they executed the same for the purpose and consideration therein expressed. Given Under My Hand and Seal of Office this the 11th day of August A. D. 1938. Roy A. Minear, Notary Public in and for Midland County, Texas. (Seal.)

[fols. 73-75] STATE OF TEXAS,
County of Midland:

Before me, the undersigned, a Notary Public in and for said County and State, on this day personally appeared R. G. Lawton, agent for The McAlester Fuel Company, known to me to be the person and officer whose name is subscribed to the foregoing instrument and acknowledged to me that the same was the act of the said The McAlester Fuel Company, a Delaware Corporation, and that he executed the same as the act of such corporation for the purpose and consideration therein expressed, and in the capacity therein stated. Given Under My Hand and Seal of Office this the 11th day of August A. D. 1938. Roy A. Minear, Notary Public in and for Midland County, Texas. (Seal.)

PETITIONER'S EXHIBIT 8

August 22, 1938.

Messrs. L. H. Choate and Fred T. Hogan, Midland, Texas.

GENTLEMEN:

Referring to the contract of purchase executed by The McAlester Fuel Company with you under date of August 11, 1938: Please carry out this contract of purchase by execution of instrument of conveyance to Sylva Oil Company instead of to The McAlester Fuel Company.

Yours very truly, The McAlester Fuel Company, by
J. G. Puterbaugh, President.

[fol. 76] IN THE TAX COURT OF THE UNITED STATES

DOCKET ENTRIES

1941

Jun. 16—Petition received and filed. Taxpayer notified. (Fee paid).

1941

Jun. 16—Copy of petition served on General Counsel.

Aug. 5—Answer filed by General Counsel.

Aug. 5—Request for hearing in Dallas Texas filed by General Counsel.

Aug. 9—Notice issued placing proceeding on Dallas Texas calendar. Service of answer and request made.

1942

Mar. 25—Hearing set May 4, 1942 in Dallas Texas.

May 5—Hearing had before Mr. Opper—on the merits—submitted—Motion of counsel to consolidate. Granted. Motion of petitioners to amend petition in docket 107630-107886-7-8, Granted. Motion to amend and amended petitions filed in 107630-107886-7-8. Oral answers to amended petitions in dockets 107630-107886-7-8. Appearance of James H. Yeatman and Claude Collard, Agreed statement of facts all filed at hearing. Briefs due July 6, 1942. Reply briefs July 21, 1942.

May 16—Transcript of hearing 5-5-42 filed.

Jul. 3—Brief filed by General Counsel.

Jul. 6—Motion for extension of time to Aug. 6, 1942 to file brief filed by taxpayer 7-6-42. Granted.

Aug. 3—Brief filed by taxpayer 8-3-42. Copy served on General Counsel.

Dec. 9—Memorandum findings of fact and opinion rendered. Opper, Judge. Decision will be entered under Rule 50. Copies served 12-9-42.

1943

Jan. 5—Computation of deficiency filed by General Counsel.

Jan. 7—Hearing set Feb. 10, 1943 on settlement.

[fol. 77]

Jan. 30—Computation of deficiency filed by taxpayer. 2-3-43. Copy served on General Counsel.

Feb. 10—Hearing had before Judge Murdock on settlement under Rule 50. Respondent agrees to petioner's computation. Referred to Judge Opper for decision.

Feb. 12—Decision entered. Clarence V. Opper, #14.

Apr. 29—Motion for leave to file motion for amendment of findings of fact—motion for amendment lodged, filed by taxpayer.

1943

May 1—Petition for review by U. S. Circuit Court of Appeals, 10th Circuit, with assignments of error filed by taxpayer.

May 3—Petition for review by U. S. Circuit Court of Appeals 10th Circuit, filed by General Counsel.

May 3—Notice of filing petition for review sent to James H. Yeatman filed.

May 6—Motion of 4-29-43 denied.

May 11—Proof of service of petition for review on J. P. Wenchell filed by taxpayer.

May 18—Proof of service of filing petition for review (James H. Yeatman) filed by General Counsel.

May 19—Proof of service of filing petition for review (Dr. W. G. Choate) filed by General Counsel.

May 22—Motion for extension 7-31-43 to transmit record filed by General Counsel.

May 22—Order enlarging time to July 31, 1943 to prepare and deliver the record entered.

Jun. 7—Motion for extension to 7-31-43 to transmit record filed by taxpayer.

Jun. 7—Order enlarging time July 30, 1943 to prepare and deliver the record entered.

[fol. 78] Clerk's Certificate to foregoing transcript omitted in printing.

[fol. 79] IN THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE TENTH CIRCUIT

ORDER OF SUBMISSION

First Day, January Term, Monday, January 17th, A D. 1944. Before Honorable Orie L. Phillips and Honorable Sam G. Bratton, Circuit Judges, and Honorable T. Blake Kennedy, District Judge.

These causes came on to be heard and were argued by counsel, James H. Yeatman, Esquire, appearing for W. G. Choate, Helen Goodner appearing for Commissioner of Internal Revenue.

Thereupon these causes were submitted to the court.

In United States Circuit Court of Appeals

Opinion—March 13, 1944

James H. Yeatman for Petitioner and Cross-Respondent Choate.

Helen Goodner (Samual O. Clark, Jr., Assistant Attorney General, and Sewall Key and A. F. Prescott, Special Assistants to the Attorney General, were with her on the brief) for Respondent and Cross-Petitioner Commissioner of Internal Revenue.

Before Phillips and Bratton, Circuit Judges, and Kennedy, District Judge.

Kennedy, District Judge, delivered the opinion of the Court:

This is a tax case in which the taxpayer and the Commissioner of Internal Revenue have petitioned for review of an order of the Tax Court of the United States entered on February 12, 1943.

Briefly stated the litigation arises out of the following circumstances: One Baker executed an oil and gas lease on land owned by her in fee to one Tunstill, which lease provided for a cash consideration with an over-riding royalty. Subsequently, and by mien conveyances, the lease came into the ownership of a co-partnership known as Choate and [fol. 80] Hogan. In 1938, under a contract with the McAlester Fuel Company, a sale was arranged for, which was subsequently carried out by mutual agreement of the parties through an assignment to the Sylvia Oil Company. These instruments provided that Choate and Hogan should convey all their right, title and interest, amounting to 11/16ths of the lease, together with all wells and equipment including pumps, casing, pipe, tanks, leasehouse and other personal property on or used in connection with the premises, including oil in storage, for a consideration of $110,000.00, save and except that Choate and Hogan reserved to themselves 1/8th of 8/8ths of all oil and gas and casinghead gas which should be produced and saved by the purchasing company above a certain depth specifying particularly that said reserve over-riding royalty should be 1/16th of 8/8ths in favor of Choate and 1/16th of 8/8ths in favor of Hogan. The interest of Choate is the only one at issue in this case

and arises under a deficiency assessment for taxation by the Commissioner of Internal Revenue after Choate had made his return for tax purposes in 1938. In making such return the taxpayer computed the tax upon the basis of a sale by allocating the sale price of $110,000.00 as $98,454.70 to the leasehold and $11,545.30 to equipment. The amount allocated to the leasehold was considered on the basis of a long-term capital gain and the amount allocated to equipment was accounted for through depreciation and the tax computed on the remaining difference. The Commissioner computed the tax upon the entire amount of cash consideration upon a depletion basis. Upon appeal the Tax Court sustained the Commissioner as to the computation by the depletion method upon the amount allocated to the leasehold but allowed the taxpayer a computation of the amount allocated to equipment by depreciation. Upon the first part of the decision of the Tax Court the taxpayer seeks review and the Commissioner upon the second.

We are of the opinion that the original conclusions of the Commissioner were correct. Burnet v. Harmel, 287 U. S. 103; Palmer v. Bender, 287 U. S. 551; McLean v. Commissioner, 5th Cir., 120 Fed. 2d, 942; Commissioner v. O'Shaughnessy, 10th Cir., 124 Fed. 2d, 33. These cases hold that the interests of the taxpayer in this situation for [fol. 81] taxation purposes are determined by depletion. In the Palmer case it is said:

> "* * * Similarly, the lessor's right to a depletion allowance does not depend upon his retention of ownership or any other particular form of legal interest in the mineral content of the land. It is enough if, by virtue of the leasing transaction, he has retained a right to share in the oil, in place, which is depleted by production. * * * When the two lessees transferred their operating rights to the two oil companies, whether they became technical sublessors or not, they retained, by their stipulations for royalties, an economic interest in the oil, in place, identical with that of a lessor."

While there may be criticism of the manner in which purported contracts of purchase and sale of leaseholds are characterized by use of the term "sublease", yet it remains clear in principle that where the seller or the lessor retains an interest in the oil in place, his rights therein are

of the same character as those of the purchaser or lessee and subject to depletion.

As to the second point covered by the cross-petition for review by the Commissioner, as intimated, we hold that the computation as to equipment covered by the transaction was likewise subject to the depletion method instead of by the allowance of depreciation as determined by the Tax Court. Cullen v. Commissioner, 5th Cir., 118 Fed. 2d., 651. In cases where the leasehold is not specifically sold separate and distinct from the equipment thereon and the consideration for each specifically segregated the transaction must be considered in its entirety and the cost made recoverable through depletion. In the case at bar no such distinction and separation was made as the cash to be paid covered the leasehold and the equipment as a unit. In a case in our own Court, in Commissioner v. Lewis, 10th Cir., 132 Fed. 2d, 709, it was held upon the facts there presented that the oil reserves and the equipment were sold separately and such had been the finding of the Commissioner. In discussing that phase of the case the opinion says:

> "Ordinarily, a producing oil property consists of the oil reserves and the equipment; and where such [fol. 82] a leasehold estate is sold and conveyed as a unit for an agreed consideration, part in cash and part in oil payment, the cost of the leasehold including the equipment should be allocated between the part sold and the part reserved in proportion to their respective values. But in making the sale of such a leasehold estate, contracting parties are not forbidden by law or public policy to treat the oil reserves and the equipment separately. A vendor may convey an interest in the former, reserve an interest to be paid out of production, and convey the latter with no reservation. That was done here. By the plain terms of the contract, the vendors sold an interest in the oil reserves, reserved an interest to be paid out of production, and sold the equipment outright. They did not retain title, lien, or any kindred economic interest in the equipment. They reserved in it only an option to purchase at its salvage value in the event the vendee should elect to discontinue operations before full payment of the deferred amount out of production. Other than such option, they did not reserve or retain any right what-

ever in the equipment. The contract is clear and not open to any other construction. Therefore in computing the net gain derived by the vendors from the sale, the remaining undepreciated basis of the equipment was deductible in whole from the cash payment. No part of it was allocable to the retained interest."

In the case at bar the instruments clearly on their face reflect that the transaction was one in entirety covering both the oil reserves and the equipment and that consequently the depletion method must be applied to the entire consideration. If the rule were otherwise, it would permit the taxpayer to postpone his determination in segregation of items covered by the cash consideration until he might ascertain the course most advantageous to his pecuniary gain.

The order of the Tax Court is affirmed in No. 2789 and reversed in No. 2790. The proceeding will be remanded to the Tax Court for further action in conformity with the views herein expressed.

[fol. 83] PHILLIPS, Circuit Judge, dissenting in part:

It is my opinion that there was a sale of the equipment and that W. G. Choate and his co-owners retained no interest therein. If this be true, then W. G. Choate was entitled to deduct the depreciated cost of the equipment if it was sold for an amount in excess thereof, or one hundred per cent of the loss if it was sold for an amount less than the depreciated cost. While it is not expressly stated, I conclude from paragraphs 7 and 9 of the agreed statement of facts that the equipment was held for less than eighteen months. Accordingly, it becomes unnecessary to allocate the sale price as between lease and equipment. The mathematical result is the same, whether you deduct the depreciated cost of the equipment from the entire sale price or allocate a portion of the sale price to equipment, deduct the depreciated cost, and determine the gain or loss accordingly. I am unable to see how, under the provisions for depletion of oil and gas wells, a taxpayer can ever recover either his depreciated cost or his capital loss resulting from the sale of equipment. Oil and gas depletion is based not on cost but on a per centum of gross income. See 26 U. S. C. A. §§ 23(m) and 114(b)(3). It would in no wise be in-

creased by reason of depreciation of the equipment. Accordingly, I am of the opinion that the decision of the Tax Court should be affirmed in its entirety. This view is supported by Hogan vs. Commissioner, 5th Cir. (decided February 25, 1944) — F. (2) —.

In United States Circuit Court of Appeals

Judgment

Twenty-seventh Day, January Term, Monday, March 13th, A. D. 1944. Before Honorable Orie L. Phillips and Honorable Sam G. Bratton, Circuit Judges, and Honorable T. Blake Kennedy, District Judges.

These causes came on to be heard on the transcript of the record from The Tax Court of the United States and were argued by counsel.

On consideration whereof, it is now here ordered and adjudged by this court that the decision of the said The Tax Court of the United States, insofar as it relates to cause [fol. 84] No. 2789, be and the same is hereby affirmed; and that the decision of the said The Tax Court of the United States, insofar as it relates to case No. 2790, be and the same is hereby reversed, and the cause be and the same is hereby remanded to the said The Tax Court of the United States for further proceedings in accordance with the views expressed in the opinion of the court.

[fol. 85] In United States Circuit Court of Appeals
January Term, 1944

Nos. 2789-2790

[Title omitted]

Motion for Rehearing—Filed April 3, 1944

To the Honorable Judges of the United States Circuit Court of Appeals for the Tenth Circuit:

Now comes W. G. Choate by his attorney, James H. Yeatman, and files this his motion for rehearing in the above entitled causes. The grounds for this motion are as follows:

[fol. 86] (1) The primary function and duty of a court is to decide the issues presented to it, if it has jurisdiction to

do so. In these proceedings, this Honorable Court has utterly failed in such duty. One of the questions presented was whether the petitioner had made a sale of an interest in an oil and gas lease such as would entitle him to report the profit as capital gain under Section 117 of the Internal Revenue Code. Nowhere in the decision does it appear that this Honorable Court has undertaken to answer said question. This Honorable Court has decided this particular issue against the petitioner by determining how the cost of the property sold is to be recovered and by considering whether petitioner is entitled to depletion on the net cash received from the sale. Neither the question of cost return nor depletion was the issue in this Honorable Court, or in the court below. In computing the tax deficiency shown by the deficiency notice, the Commissioner allowed depletion on the net cash received by petitioner and below no issue was raised on this point or on the question of the method of cost recovery. The sole and only question presented to this Honorable Court and to the court below was whether or not petitioner had made a sale of a part of his interest in the Baker oil and gas lease. This question remains unanswered by this Honorable Court. In the interest of fairness and justice to this petitioner and hundreds of other taxpayers similarly situated, we respectfully request and urge that this Honorable Court grant a rehearing and determine whether the transaction which the Choate and Hogan partnership had with Sylva Oil Company amounted to a sale of an interest in the Baker lease, and if it finds that the transaction was a sale that it reverse The Tax Court's decision on this point.

For the information of the Court in passing on this motion for rehearing, we wish to point out the following with respect to the statement made in the opinion that where the [fol. 87] seller or the lessor retains an interest in the oil in place his rights are of the same character as those of the purchaser or lessee and subject to depletion. This statement is only partially correct. It is correct as to that part of the minerals *retained* by the vendor, but it is not correct as to that part of the minerals which are *disposed* of by the vendor. The depletion allowance is a creature of statute and under the statutes now in force it would seem that the allowance can be made only as to income derived from production of the minerals and that it is not allowable against income from the sale of the minerals in place. There are

only two subsections of the Code which deal with this subject, the first of which is Section 23 (m) which provides that "in computing net income there shall be allowed as deductions * * * in the case of mines, oil and gas wells, other natural deposits and timber a reasonable allowance for depletion * * *. In any case in which it is ascertained as a result of operations or development work that recoverable units are greater or less than prior estimates thereof then such prior estimate shall be revised and the allowance under this subsection for subsequent taxable years shall be based upon such revised estimate."

The second subsection dealing with the subject is Section 114(b) (3), which in part reads "in the case of oil or gas wells the allowance for depletion under Section 23 (m) shall be 27½ percentum of the *gross income from the property* during the taxable year, et cetera."

This court in Commissioner v. O'Shaugnessy, 124 Fed. (2d) 33, quoted the following from the opinion of Helvering v. Bankline Oil Company, 303 U. S. 362, that "In order to determine whether respondent is entitled to depletion with respect to the production in question we must recur to the fundamental purpose of the statutory allowance. The deduction is permitted as an act of grace. *It is permitted in recognition of the fact that the mineral deposits are wasting* [fol. 88] *assets and it is intended as compensation to the owner for the part used up in production.*"

We think it plain from the foregoing quoted matter, from Section 23 (m) and Section 114 (b) (3), and from what the Supreme Court said in the Bankline case that the allowance for depletion is applicable only to income derived from production of minerals and is not applicable to income derived from the sale of the minerals or part of the minerals in place. It is not believed that said statutes, or the Supreme Court's decision in the Bankline case can be interpreted otherwise. The income in controversy in this case was not derived by petitioner from production of the oil and gas underlying the Baker lease. It was derived by petitioner from the sale of a part of his interest in the oil and gas in place which went over to the Sylva Oil Company. This statement is not subject to refutation. Although, as stated above, the question of how petitioner's cost is to be returned to him is not the issue in this case, we submit that under the statutes, this Court has erred in its conclusion that the cost

of petitioner's interest in the Baker lease is recoverable through depletion.

The second question presented in these proceedings is whether or not petitioner is entitled to deduct the undepreciated cost of the equipment which was on the Baker lease at the time the transaction with the Sylva Oil Company was had. This Court in reversing The Tax Court holds that the cost of the equipment is recoverable through the depletion method instead of "by allowance for depreciation" as determined by The Tax Court and cites Cullen v. Commissioner (5th C. C. A.), 118 Fed. (2d) 651, and Commissioner v. Lewis (10th C. C. A.), 132 Fed. (2d) 709. The holding in the Cullen case that the cost of the equipment on the leases with respect to which overriding royalties were retained is recoverable through percentage depletion was reversed by [fol. 89] the Fifth Circuit Court of Appeals in the companion to this case, Commissioner of Internal Revenue v. Fred T. Hogan (5th C. C. A.), decided Feb. 25, 1944, — Fed. (2d) —. With respect to this point, the Fifth Circuit Court of Appeals said:

> "We also agree with The Tax Court that title to the equipment passed from the partnership to Sylva Oil Company under the assignment, and that the partnership was entitled to deduct from the cash consideration the depreciated cost of said equipment. The assignment conveyed to Sylva Oil Company not only an interest in a producing oil and gas lease, but all equipment thereon. Under the Act, depletion percentage on the bonus received and the royalty reserved is not a deduction associated with equipment cost. Equipment cost is recoverable through depreciation allowances and not 'by percentage depletion allowances,' as apparently was inadvertently stated in Cullen v. Commissioner. It is only with respect to wasting assets that depletion allowances are made."

With respect to the conclusion reached in the majority opinion that the decision in the Lewis case is not controlling because there the equipment was sold separately and here the leasehold and equipment were sold as a unit, we respectfully urge upon this Court that the equipment involved in the present case was sold just as separately as was the equipment involved in the Lewis case. This is clear from

an examination of the language of instruments of conveyance involved in said cases, from which we quote:

[fol. 90]

Lewis Case

"In 1935 the partnership purchased two nonproducing oil and gas leases for a total consideration of $120. Upon these leases the partnership placed certain equipment for the production of oil. On March 23, 1937, the partnership sold the two leases for a cash consideration of $150,000 and an oil payment of $125,000 payable out of one-fourth of seven-eighths of any oil produced from the leases. The contract provided in part as follows:

"'4. It Is Further Understood and Agreed that for the consideration above named, said Second Party (vendee) shall be entitled to all of the material now in the ground on said aforedescribed premises, as well as the derricks over the wells now producing, or in the course of drilling on said aforedescribed premises, together with the lead-lines, well-head connections, tank battery, separators, and water wells now situated on said aforedescribed premises.' (Findings of Fact by Tax Court, Memo Op. entered Jan. 22, 1942.)

Choate Case

"Now, therefore, for and in consideration of One Dollar ($1.00) and other good and valuable considerations, the receipt of which is hereby acknowledged, the undersigned L. H. Choate and Fred T. Hogan, * * * do hereby bargain, sell, assign and convey, subject to all of the terms and conditions, and the reservation of 1/16th overriding royalty in said assignment from Continental Oil Company to Roy R. Brown, all right, title and interest of the original lessee and the present owner in and to said lease, and rights thereunder or incident thereto, in so far as the same covers and affects the oil, gas and casinghead gas, and the oil, gas and casinghead gas right, at and above the depth of two thousand seven hundred fifty feet from the surface in and under the said 230 acres of land above described, together with all wells and the equipment thereof, including pumps, casing, piping, tanks, lease house, and all other personal property on or used in connection with said premises, including oil in storage to Sylva Oil Company, * * *." (R. p. 20.)

[fol. 91] It is true that in the present case the consideration paid by the vendee was in a lump sum amount for both the leasehold and the equipment thereon. But the same thing was true in the Lewis case. The above quotation from the conveyance in the Lewis case shows that no division of the consideration was made as between leasehold and equipment. Then how can it be said that in the Lewis case the equipment was sold separately and here that the leasehold and equipment were sold as a unit? If the words "It is further understood and agreed that for the consideration above named" appearing in the Lewis assignment are substituted for the words "together" in the Choate assignment, the assignments would be in all substantial respects the same. We submit that the difference between the two assignments is in verbiage only and that in substance no valid distinction exists between the two cases.

Choate and Hogan were partners. The assignment in the present case is the same assignment as was involved in the case of Commissioner v. Hogan, supra. As previously stated, the Fifth Circuit Court held that the cost of the equipment was deductible from the cash consideration paid the partnership for the lease as determined by The Tax Court, and reversed its decision in the Cullen case which the majority cited in support of the conclusion that the cost of the equipment is recoverable through the "depletion method." Thus we have the tax liability of members of the same partnership arising out of the same transaction computed upon different bases and with different tax results to each partner.

We submit on this point that a rehearing should be granted and the decision of The Tax Court should be affirmed for the following reasons:

1. The decision of the Fifth Circuit Court in Culler v. Commissioner, supra, which this Court cited and evidently [fol. 92] relied on in reaching the conclusion that the cost of the equipment is recoverable through depletion, was reversed in Commissioner v. Hogan, supra, and the Cullen decision is therefore no longer any authority for such proposition.

2. There is no substantial difference between the present case and Commissioner v. Lewis, supra, and the Lewis decision establishes the law of this case. In this case just as

in the Lewis case title to all of the equipment on the lease passed to the vendee.

3. The cost of depreciable property cannot be legally recovered through depletion allowances. It can be recovered only through annual depreciation allowances or as an offset against the consideration received for the property. (See Statutes cited page 34 of petitioner's original brief and Judge Phillips' dissenting opinion.)

Wherefore, it is prayed that a rehearing be granted and that upon same being had this Honorable Court reverse the decision of The Tax Court in No. 2789 and affirm the decision of The Tax Court in 2790.

James H. Yeatman, Counsel for W. G. Choate.

[fol. 93] James H. Yeatman, counsel for petitioner, W. G. Choate, certifies that he prepared the within Motion for Rehearing; that said motion is believed to be meritorious; that it is not vexatious; and is not interposed for the purpose of delay.

James H. Yeatman, Counsel for W. G. Choate.

Of Counsel: Vinson, Elkins, Weems & Francis, 11th Floor Esperson Building, Houston 2, Texas.

[File endorsement omitted.]

[fols. 94-95] In United States Circuit Court of Appeals

Order Denying Petition for Rehearing

Forty-second Day, January Term, Saturday, April 8th, A. D. 1944. Before Honorable Orie L. Phillips and Honorable Sam G. Bratton, Circuit Judges, and Honorable T. Blake Kennedy, District Judges.

These causes came on to be heard on the petition of W. G. Choate for a rehearing herein.

On consideration whereof, it is now here ordered that the said petition be and the same is hereby denied.

On April 19, 1944, the mandate of the United States Circuit Court of Appeals, in accordance with the opinion and judgment of said court, was issued to The Tax Court of the United States.

Clerk's Certificate to foregoing transcript omitted in printing.

[fol. 96] SUPREME COURT OF THE UNITED STATES

ORDER ALLOWING CERTIORARI—Filed October 9, 1944

The petition herein for a writ of certiorari to the United States Circuit Court of Appeals for the Tenth Circuit is granted, limited to the second question presented by the petition for the writ and the case is transferred to the summary docket.

And it is further ordered that the duly certified copy of the transcript of the proceedings below which accompanied the petition shall be treated as though filed in response to such writ.

[fol. 97] IN THE SUPREME COURT OF THE UNITED STATES

STIPULATION AS TO PRINTING OF RECORD—Filed October 26, 1944

It is stipulated and agreed by and between the parties, by and through their respective attorneys of record, that the following parts of the record may be omitted from the record to be printed for this court, said omitted matter not being essential to the consideration of the question as to which the petition for certiorari was granted by this court.

1. Page 9 of the record, all of Exhibit "B";
2. Page 15 of the record, all of Exhibit "C";

• • • • • • •

4. Page 48 of the record, all of petitioner's Exhibit 1;
5. Page 59 of the record, all of petitioner's Exhibit 2;
6. Page 61 of the record, all of petitioner's Exhibit 3;
7. Page 63 of the record, all of petitioner's Exhibit 4;
8. Page 66 of the record, all of petitioner's Exhibit 5;
9. Page 68 of the record, all of petitioner's Exhibit 6;

• • • • • • •

[fol. 98] 11. Pages 73-74 of the record, all of petitioner's Exhibit 9;

12. Pages 74-75 of the record, all of petitioner's Exhibit 10;

13. Page 75 of the record, all of petitioner's Exhibit 11.

James H. Yeatman, Counsel for Petitioner; Charles Fahy, Solicitor General, Counsel for Respondent.

[fol. 99] [File endorsement omitted.]

Endorsed on Cover: Enter Charles I. Francis. File No. 48,519. U. S. Circuit Court of Appeals, Tenth Circuit. Term No. 93. W. G. Choate, Petitioner, vs. Commissioner of Internal Revenue. Petition for a writ of certiorari and exhibit thereto. Filed May 23, 1944. Term No. 93 O. T. 1944.